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INFO RUEHBJ/AMEMBASSY BEIJING PRIORITY 3080
RUEHLO/AMEMBASSY LONDON PRIORITY 0954
RUEHKO/AMEMBASSY TOKYO PRIORITY 3222
RUEHHK/AMCONSUL HONG KONG PRIORITY 3326
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TREASURY FOR IA/ISA/WINSHIP, CHRISTOPULOS, AND POGGI
NSC FOR TONG

E.O. 12958: DECL: 09/05/2017

TAGS: [EFIN](#) [EINV](#) [ECON](#) [PGOV](#) [PREL](#) [KS](#)

SUBJECT: THE LONE STAR SAGA CONTINUES: HONG KONG SHANGHAI
BANKING CORP. BIDS FOR KOREA EXCHANGE BANK

REF: (A) SEOUL 1227 (B) SEOUL 1966

Classified By: A/ECON MIKE SPANGLER FOR REASONS 1.4 B&D.

11. (C) SUMMARY: On September 3, Lone Star Funds (LS), a Dallas-based private equity firm, agreed to sell its 51-percent management stake in Korea Exchange Bank (KEB) to Hong Kong Shanghai Banking Corporation (HSBC) for USD 6.3 billion, pending regulatory approval. The sale would permit LS to cash out of its largest investment in Korea to date and give HSBC its long-sought entry into Korea's lucrative banking market. The deal requires HSBC to clear three hurdles; it must (1) complete its due diligence by October 15, (2) submit its take-over application to the Financial Supervisory Commission (FSC) by January 31, 2008; and (3) obtain regulatory approval by April 30, 2008. If the FSC has not approved the take-over by April 30 of next year, the tender agreement will expire without penalty, if not renewed.

Many observers expect the FSC to resist approving the HSBC application until ongoing court cases are decided concerning a criminal conspiracy to sell KEB to LS at an understated price. These cases could take up to three years including the appellate process. Citing these cases, the FSC has rejected earlier attempts by Kookmin Bank and Development Bank Singapore to purchase KEB. We expect to receive a formal LS request soon to assist LS to obtain regulatory approval for the sale. END SUMMARY.

LONE STAR HERE SINCE 1999

12. (SBU) LS arrived in Korea in early 1999 and invested approximately \$3.1 billion in various investments including an office building (Star Tower), two firms (Star Leasing and Kukdong Engineering and Construction), and, during 2003, KEB.

The KEB investment totaled about \$2 billion and therefore represents LS's largest investment in Korea to date. Since 2005, LS has not identified any new investments in Korea but is maintaining a "long-term" perspective to identify additional under-valued, generally distressed assets, according to a LS officer.

THE DEAL

13. (C) LS agreed on September 3 to sell its 51-percent management stake in KEB to HSBC for USD 6.3 billion. This sale would permit LS to cash out of KEB at a 24-percent premium to the current stock market price and realize a

considerable profit. This potential profit has attracted the attention of the Board of Audit and Inspection, the National Tax Service, and the Financial Supervisory Service, all of which have raided LS offices frequently over the past two years in apparent attempts to challenge LS's claims to having made proper transactions and being due special tax treatment through their tax-exempt Belgian office. Against the backdrop of this official scrutiny and adverse media comment, the Seoul Prosecutor's Office is pursuing criminal cases against several LS and former KEB officials for allegedly pursuing a conspiracy to buy KEB at an understated price in May 2003 and purchasing KEB's credit card issuer due to fraudulent stock market manipulation in November 2003 (Ref A).

THREE MILESTONES

14. (SBU) The recently inked agreement offers HSBC a long-sought chance to enter Korea's lucrative banking market. In 2004, HSBC had tried to buy Korea First Bank but lost out to Standard Chartered. HSBC must now clear three hurdles to purchase KEB. It must (1) complete its due diligence by October 15, (2) submit its take-over application to the Financial Supervisory Commission (FSC) by January 31, 2008; and (3) obtain regulatory approval by April 30, 2008. If the FSC has not approved the take-over by January 31 of next year, HSBC must pay an additional USD 133 million to buy KEB. More critical, if the FSC fails to approve by April 30, 2008, the tender agreement will expire without penalty unless renewed.

THREE TIMES A CHARM?

15. (C) LS is now into its third serious attempt to sell KEB over the past year. The September 3rd agreement with HSBC follows Kookmin Bank's October 2006 attempt to buy a 66-percent stake in KEB and DBS's May 2007 attempt to purchase it at undisclosed terms. The Kookmin bid failed because the FSC insisted LS could not tender the shares while the criminal trials were proceeding on the alleged criminal conspiracy to sell the bank to LS and the stock manipulation case concerning KEB's credit card issuer. The DBS attempt purportedly failed because the FSC objected to its sale to a bank controlled by Temasek, a Singapore state-owned enterprise. At the same time that LS is pursuing the HSBC deal, the FSC is now reassessing whether LS is a qualified majority stakeholder in KEB. This investigation may have legal implications for the ongoing court cases and is widely expected to be decided next month.

ASKING FOR HELP

16. (C) KEB President Richard Wacker recently notified us that LS will soon formally request help from the USG to persuade the FSC to approve the deal. Wacker indicated that the pending criminal cases and the FSC investigation into LS's status as a "qualified majority stakeholder," however they are rendered, should not nullify LS's purchase or otherwise affect KEB's sale. Such decisions would simply force LS to divest itself of KEB within six months of their disposition, something LS is willing to do now. Wacker also believes the ROKG should seize the opportunity to encourage foreign investment since HSBC's credentials are impeccable and Korea aspires to become a regional financial hub. Wacker noted that the UK Ambassador to Korea would receive a similar request from HSBC to approach the FSC.

COMMENT

17. (C) Through its many twists and turns, the LS saga constitutes a learning curve charting how Koreans perceive private equity firms and how foreign investors see the investment climate here. At the moment, most observers feel Korea should be further along the curve and predict that the FSC will continue to block the LS sale to HSBC until the court cases are settled. LS's legal advisor predicts these cases could take up to three years including the appellate

process.

18. (C) We will be conveying any formal request from LS for assistance to Washington for review. It is important to note Korea's Finance Minister has recently called for the establishment of domestic private equity firms, hedge funds, and large investment banks in the wake of the passage of the Capital Markets Consolidation Act (Ref B). It is difficult to see how this goal can be achieved while regulators continue to drag their feet on this major bank acquisition deal that would further Seoul's transformation into a regional financial hub. End comment.
VERSHBOW